

**LIBA ISDA**

**Response to European Commission consultation on the Treatment of CIUs in the  
Trading Book and Banking Book**

**4 March 2004**

<b>Introduction.....</b>	<b>2</b>
<b>Summary Recommendation.....</b>	<b>2</b>
<b>Preferred option.....</b>	<b>3</b>
<b>Summary of high level concerns:.....</b>	<b>3</b>
<b>Definition of a CIU.....</b>	<b>4</b>
<b>Eligibility Criteria.....</b>	<b>5</b>
<b>CIU Treatment in the Trading Book .....</b>	<b>6</b>
<b>Index Tracked Funds treatment: Conditions for availability.....</b>	<b>6</b>
<b>Full look through for exchange traded CIUs .....</b>	<b>7</b>
<b>Partial look through.....</b>	<b>8</b>
<b>Modified Gold method for FX .....</b>	<b>8</b>
<b>CIUs in the banking book .....</b>	<b>9</b>
<b>Impact of Fair Value Accounting .....</b>	<b>9</b>
<b>Lack of proportionality - Unduly penal fall back position.....</b>	<b>9</b>
<b>Ratings and conceptual consistency with Securitised positions.....</b>	<b>9</b>
<b>ANNEX: Risk Assessment of CIUs .....</b>	<b>11</b>

## **Introduction**

ISDA and LIBA (the Associations) welcome the opportunity of responding to the latest set of proposals from the European Commission on the prospective treatment for holdings in Collective Investment Undertakings (CIUs) in the new capital adequacy framework. Naturally, though, the tight timescale restricts our ability to respond as comprehensively as we would wish.

We recognise the importance of delivering a more advanced approach for CIUs than currently exists and we believe it is important to achieve at least a “first step” in the forthcoming directive proposal. We welcome the progress that has been made on the treatment for ETFs in the Trading Book. This is progress on which we would like to build and which is critical to the growth and success of the European ETF market. As you know, we welcome and support the principle of “Look Through” to the positions underlying the CIU.

It is essential to stress, however, that the task of designing a CIU treatment must meet both the needs of the present market, and of the future market as it may wish to develop and in this context we do not believe that the principle of look through has been elaborated as effectively as it needs to be. Hence we are concerned that the regulatory options that are offered remain sufficiently onerous that a significant proportion of CIU investments will be subject to harsh capital treatment which does not accord with the risk profile that typifies this sector.

We are sorry that we are not able to offer more data to illustrate our views, but the short period of time available for consultation has excluded this possibility. Equally, though, we would also have liked to have seen data and impact estimates from the Commission in respect of its proposals. We understand that time is a major constraint, but we are concerned that the EC does not itself have a clear view of the likely impact of its proposals.

We retain many questions and concerns relating to many of the treatments that are offered for proposal. Some of our concerns and queries have been expressed before and we re-iterate them again as we do not think we are in a position to develop the debate constructively with the Commission without greater insight into the underlying regulatory concerns and beliefs. Other of our concerns relate directly to the current iteration of the proposals which we believe need further careful analysis and impact assessment to ensure that anomalous and inappropriate capital treatments are not created.

## **Summary Recommendation**

We are anxious that there should be some legislative progress made in the directive proposal (specifically that CAD Annex 1, Paragraph 11 is deleted). We would like to build on the strengths that we perceive in the current set of proposals, but we do not think that these proposals are sufficiently well developed to provide a comprehensive treatment and therefore we believe it is important that the directive (a) does not include all the proposals as they are currently articulated and (b) is drafted in such a way as to permit the evolution of a more proportionate and genuinely risk sensitive

capital treatment. We set out below our preferred option for action by the EC and a summary of our high level concerns.

**(i) Preferred option**

In respect of the Trading Book treatment we support the proposals for ETFs but believe that the remaining treatments are too onerous. Hence we continue to recommend a treatment for non-ETFs based on the categorisation of a fund (i.e. in equities, debt etc) on which a standard Market Risk Treatment can be based. A pillar 2 process can assess any meaningful risk exposure to leverage of a fund. We refer the Commission to our earlier proposals..

We believe that the treatment in the Banking Book also needs to be re-considered, and regulatory recognition of External Credit Ratings built into the proposals.

We believe that, in the time available before the Commission must put forward a legislative proposal, it will not be possible to refine a treatment that reflects the true risks of all CIUs, whether held long term in the banking book, or short term in the trading book. Hence we stress the importance of the Commission ensuring that the directive drafting makes progress on the treatment of ETFs to prevent the European ETF market falling further behind the US ETF market, and allows for sufficient flexibility to provide for further changes for the range of CIUs. If the authorisation criteria, for example, were to require a co-decision procedure to be amended, the CIU market and its future development would be significantly damaged. As the EC has not been able to undertake any impact assessment of this consequence, we believe it is imperative not to hard code a requirement that could inflict long term damage to the markets.

**(ii) Summary of high level concerns:**

**Too great a reliance on the assumption of “worst case scenario.”** The proposals rely on this principle in the treatment of FX, Leverage and in Partial Look through. We are unaware of any evidence that suggests that the worst potential outcome is statistically significant in the behaviour of CIUs to date. Nor is this attitude consistent with the calibration and construction of the rest of the revised capital framework.

**Adverse potential impact:** As noted above, we welcome the development on ETFs, but have significant concern with respect to the likely impact with respect to other CIUs. Although there has been no time to conduct proper impact assessment, a number of our members have informed us that indicative calculations show that the EC proposals would largely extinguish their capital base. In consequence these firms would naturally have to exit the market, though firms with non EU parents may have the option of continuing to use non EU entities to trade.

**Greater consistency of approach needed in a number of areas.** In particular, we note that there is no recognition of the existence of ratings for CIU products. We are also concerned that there is no assessment of correspondences to be found with securitisation positions. Some, if not all features, of the two sets of products are very similar and closer analysis is warranted.

**Conflicting regulatory objectives of eligibility criteria/penal fall back treatment.**

In our view the capital regime should be just that – a regime designed to produce an appropriate risk-sensitive capital outcome. It should not be used indirectly to achieve other supervisory objectives relating to the holding/distribution of these products. The eligibility criteria, in particular the regulation/authorisation of the CIUs, appear to be designed to exclude certain holdings that the regulators would prefer not to be held in the banking/investment firm community. We fear that this filter will capture too many instruments. Supervision/regulation may work, to a degree, as a reasonable proxy for the likely risk of the CIU, but the proposals indirectly introduce requirements designed for the protection of the retail market into a regime designed at a wholesale level for capital adequacy. We regret this confusion of aims and would encourage greater specification of the real concerns that regulators hold so that we can take the debate forward constructively. Many non regulated or supervised funds will have very modest risk profiles and it is unreasonable to exclude them from a proportionate capital treatment. Additionally we have concerns that the differences between the criteria for allocation to Trading Book and Banking Book will lead to unintended consequences which we have not ourselves had time to analyse and assess.

**Risk assessment of CIUs:** The proposals, in particular the eligibility criteria, in practice ignore existing industry standards in the risk assessment of CIUs, where due diligence focuses on liquidity risk in the underlying asset classes, strategy risk, risk of a strategy change in the CIU and Operational and fraud risk. It is by no means necessary to capture such due diligence in detailed legislative form, but it appears inappropriate that such industry practice should be given no recognition. We provide a greater discussion of these practices in the attached annex.

**Diversification and Concentration:** Ultimately, the effect of the proposals is to underplay the importance of diversification and risk reducing effects of CIUs (and funds of funds) and to promote a risk concentration as firms would end up dealing with a far more limited universe of funds. This appears to be a counter prudential outcome which we do not welcome.

**Treatment of FX and Leverage.** As we note above, there are several aspects of the proposals where we do not believe that we have a clear understanding of the regulatory concerns and rationale behind the design of the proposed regulations. These elements include notably the treatment of FX, Leverage and the implicit supposition that the relatively penal treatments under partial look through and fall back are truly proportionate to the risks of the market. We do not agree with the proposed treatments in these areas, and refer the EC to our arguments in former submissions. We therefore continue to request explanation of EC thinking and concerns as this clearly frustrates our ability to take the debate forward as effectively as we would wish.

**Definition of a CIU**

Before we discuss the proposed treatments in more detail, we would like to comment on the issue of definitions.

In our previous response of February 2003 we raised the issue of boundary definitions to ensure appropriate equivalence between CIUs and other economically similar

instruments. Furthermore we recognise the importance of delivering legal certainty, and avoiding, where appropriate undue burdens being placed on supervisors to give guidance. This is not easy, when any definition is likely to struggle to keep pace with likely innovation in the market.

If the EC wishes to draw a clearer boundary between CIUs and securitisation vehicles, we propose the following text. In practice we do not believe there is a need for a wider definition of CIU, but we favour a principles-based text describing the nature of CIU's rather than prescription. The additional language we offer here emphasises the principle of "economic substance" rather than prescriptive definition.

"Institutions should look to the economic substance of the transaction under consideration in order to determine whether the investment can be classified as a CIU holding or constitutes an investment in a securitisation tranche. Financial institutions are encouraged to consult with their national supervisors when there is uncertainty about whether a given investment should be treated as a CIU holding."

Of course, firms would typically consult with the national regulator when there was uncertainty of treatment, and this allows for the possibility of different treatments (if supervisory convergence processes are not yet very advanced) but this definition draws on the fact that one typical difference between securitisation tranches and CIU holdings lies in the stratification of risk on the liabilities' side of securitisation vehicles, which normally does not occur in CIUs. This may not, however be true in all cases.

### **Eligibility Criteria**

We believe that "authorisation for sale" should be abandoned as an eligibility criterion, to focus purely on the disclosure of investments and redeemability of units or shares. The "for sale" criterion highlights a number of concerns we have regarding the structure and content of the proposals:

**Inconsistency of treatment between Banking and Trading Book.** We note that the eligibility criteria for CIUs differ between proposed Banking and Trading Book. In practice, the set of items that can be allocated to the Trading Book is likely to be smaller than the set that can be held in the Banking Book. We have not had time to analyse in depth the potential for anomalies that may emerge as a result of this distinction. However, the curious implication would appear to be that "worst case" scenarios that have generated very cautious capital treatments under the Trading Book are, in effect, ignored in the Banking Book.

**Authorisation criterion used as a "screen" and not as a risk sensitive tool.** We are concerned that the authorisation criteria is intended to act as a filter to prevent firms from investing in funds regulators themselves have concerns over. Authorisation is a crude proxy for risk and a number of issues emerge from its use:

- Investment in funds which do not have the consumer protection features required for the retail investor is penalised thus implying that firms can invest safely only in funds that benefit from a high level of consumer protection. We had understood that regulators did not believe that it was necessary to restrict the wholesale and

sophisticated institutions to instruments that are designed to be safe for the retail consumer. In other words we believe the authorisation criterion represents an unwelcome degree of confusion of retail and wholesale objectives.

- The lack of regulated status does not, of itself, mark out a CIU as high risk. It is unwise to assume that all non regulated funds will have extreme risk profiles, even though some may well do. For this reason we are anxious to progress the discussion on what precisely it is that the regulators wish to exclude so that a more tailored approach can be designed that targets the areas of real concern and does not unwittingly capture other positions.

**Impact Assessment:** By limiting the scope of funds in which firms can invest the regulatory treatment will drive investment incentives and this obviously carries profound implications for the business concerned in the EU, the impact of which should be assessed before the Commission finalises its proposals.

**Lack of focus on Market Risks:** We are of the view that the CIU regime in the Trading Book should be about market risks – i.e. finding a proportionate response to the actual risk that is held - and should not focus on suitability/marketing regimes, which is likely to lead to perverse outcomes.

Two final points for clarification:

- We would be grateful for greater clarification on whether it is the EC's intention to capture all "non supervised" CIUs (EU or non EU) under the penal (i.e. deduction) treatments. This would appear to be the logical reading of the text as it stands, but clarity of intent would be welcome. As above, it is clearly unacceptable if this is the intention of the proposals as regulatory capital rules should not be used as a tool to restrict certain business activities. Rather other regulations/ supervisory mechanisms should be used to control the growth of such markets if this is believed to be desirable.
- In addition, we are not clear whether there is a clear differentiation intended between the criterion for the Trading Book (para 4(a)) which requires that the CIU shall be authorised for sale to the general public in a Member State and the criterion for the Banking Book which demands that the CIU need only to be managed by a company that is subject to supervision in a Member State.

### **CIU Treatment in the Trading Book**

#### **Index Tracked Funds treatment: Conditions for availability**

At present it is unclear how lack of trade data should be handled in the context of the correlation requirement for index tracked funds. We assume, therefore that the Commission sees this issue essentially as one for implementation.

We wish to draw the Commission's attention to the fact that there is some confusion as to how this criterion would be met for new products that would not have adequate data history. We would appreciate clarification in this regard.

We cannot support the requirement for the correlation test to be based on daily price movements. This is too prescriptive and not always appropriate (particularly for new funds, and due to technical issues, for example differences in the timing of market closes between the fund and the underlying components). There would appear to be a need for guidance notes to clarify that correlation based on daily price movements may not always be appropriate, and that firms should be allowed to justify to regulators where that is the case and prove correlation on a different price frequency, for example using weekly returns.

### **Full look through for exchange traded CIUs**

We welcome the removal of the correlation test from the list of eligibility criteria under full look through. However, we question the rationale for setting the ability to redeem units in specie as a condition for use of this approach. We note that the Commission has yet to articulate the prudential rationale for insisting on redemption in specie. We assume this relates to concerns regarding basis risk, however this risk would be fully captured via decomposition. This is an area where it is important to understand the regulator's thinking and we would encourage the regulators to articulate their reasoning. If redeemability is deemed a necessary condition, it should not make a difference whether this is in cash or in specie.

We also are concerned that the full look-through treatment is only available for exchange traded CIUs. We believe that it should apply to all CIUs, whether exchange-traded or not.

With respect to the "Simple Alternative for Exchange Traded Index Track Funds" we are of the view that this alternative should be extended to all regulated index tracker funds that allow for daily redemption of units or shares at net asset value.

We also seek clarification of point 6.(d), which may or may not be welcome from an industry perspective. It would be unwelcome if read to imply that an institution's eligibility under the full look through approach will be limited to instances where the firm holds a minimum quantity of units. This would render the full look through approach unworkable, as CIU holdings vary daily and would probably breach the floor so often that firms could not make practical use of the approach. In practical terms, firms acting as market makers in CIU investments buy minimum quantities of shares or units to then sell only a proportion of these back to their clients. The quantity remaining on the market makers' books may not be sufficient to warrant redemption from the fund manager, but can normally be redeemed from other financial institutions.

However, the second sentence in 6(d) may be helpful, *if* the Commission insist on redemption in specie as there is acknowledgement that there will be rounding issues and that it is acceptable to cover those with cash. Without this, each ETF would require 100% redemption in specie to qualify, and this would probably reduce the qualifying population close to zero.

Finally, we welcome the recognition of the ability to net between the CIU's investments and positions held by institutions on their books. We would however

appreciate if the Commission would clarify that netting is possible regardless of the nature (synthetic or real) or the direction (long or short) of the positions concerned.

### **Partial look through**

We strongly object to the treatment applied under the partial look through approach. We believe this fails the test of proportionality. If for instance a fund aims to attain on average a certain rating for its investments, and if this objective is stated clearly in the mandate, then the capital charge should be based on the target rating, not on the worst case investment. Only if no information at all is available regarding the target exposure of the fund should a worst case approach be employed.

Most fund managers seek to achieve a degree of diversification in order to optimise their risk-return profile. In the vast majority of cases, only a small proportion of the fund is invested in riskier than average assets. However, the partial look through charge defined by the Commission will reflect this minority investment (which may require deduction) rather than the core composition of the fund. We had recommended in our previous comment letters that the Commission adopt CAD based standardised charges reflecting the core nature of the fund, when this is feasible (i.e. differentiating between money market, fixed income and equity). We understand that FEFSI are currently preparing a classification of funds which may be relied upon for regulatory purposes. Categorisations are also provided by ECAIs and other vendors that should be considered. We reiterate the view that these charges are more reasonable than a worst case based approach.

Similarly, assuming maximum leverage is disproportionate and uncalled for. We note in any case that the effect of leverage would be to accelerate the pace at which any loss might be made as a result of a holding in CIUs, rather than increase the loss beyond the value of the original investment.

Finally, because netting between the CIUs' investments and the firms' own positions is not possible under the partial look through or indeed under the full deduction approach, the resulting capital charge will be even more disproportionate.

### **Modified Gold method for FX**

We have already laid out in detail in previous submissions why we felt that applying a charge for FX was misconceived. The Commission has disregarded our comments on this point. We remain disappointed that the Commission has not articulated its rationale for requiring an FX charge in respect of CIU positions but not in other positions. We regard this inconsistency of approach as a significant deficiency in the Commission's proposals as we have indicated above.

As we understand it, the Commission feels that looking through to the currency in which the CIUs' investments are denominated is appropriate. If this is the case, we would wish for account to be taken of any stated CIU policy aiming at systematically hedging FX mismatches between the currency of denomination of the units and that of the underlying investments. In this instance, the relevant currency should be, regardless of whether or not the underlying investments are known, that of denomination of the units.

## **CIUs in the banking book**

In our previous submission we commented on the inconsistency between the proposed Banking and Trading Book treatments. We regret that there has not been sufficient consultation on the capital treatment of CIUs in the banking book and believe that the Commission needs to undertake substantial additional research, as outlined below, before a final position can be attained.

There are three aspects that we would draw particularly to the EC's attention, in addition to our general concern that we believe there is a likelihood of anomalous treatment between banking and trading book.

- (i) Impact of Fair Value Accounting
- (ii) Lack of proportionality - Unduly penal fall back position
- (iii) Ratings and conceptual consistency with Securitised positions

### **(i) Impact of Fair Value Accounting**

If the CIU holding is, as may be the case, accounted for at fair value, there may be little incentive for the bank to hold it in the banking book. The proposed capital treatment does not work well for exposures held at fair value. It is our understanding that IAS32-39 applies to all corporates in principle, but that the Commission has restricted the mandatory scope of its application to listed companies. Member States can, however, decide to broaden the scope on a unilateral basis, which will lead to inconsistency of incentive between jurisdictions on where these instruments may be held.

### **(ii) Lack of proportionality - Unduly penal fall back position**

The fallback treatment offered under the IRB approach to institutions that are unable to calculate the IRB charge on the CIU investments is too onerous in our view. We believe that the Commission should review its proposal to ensure that IRB firms are not penalised. It should be noted that one of the attractions of investing in CIUs is the additional diversification that the holding brings to the investing institution (for instance, acquiring exposure to Japanese risk whilst having its core business in the UK). If diversification is a motive, then it is improbable that the firm will have direct exposures to the same obligors to which the CIU is exposed. The majority of CIUs are wrappers for well understood and non-contentious products, which over time have not exhibited a high risk or skewed risk profile. The assumption of worst case scenario is not, in our view a proportionate treatment for firms unable to calculate the IRB charge on the CIU investments.

We would appreciate clarification that a firm would be allowed to apply the standardised look-through approach to one category of fund(s) and at the same time applying an IRB approach to another category of fund(s).

### **(iii) Ratings and conceptual consistency with Securitised positions**

As we have noted, the current proposal does not in our view deliver proportionality, and also fails to take account of funds that are rated. It is noteworthy that the practical

issues that need to be resolved here are closely analogous to those faced in securitisation structures where ratings are common and the issues and complexities of achieving an IRB approach on the securitisation pool are well rehearsed.

We believe that the treatment of investors in securitisation tranches offers a useful point of reference. Where the IRB charge on the securitised exposures cannot be calculated, the investor can use the external rating of the tranche as a basis for calculating regulatory capital. In general, the resulting capital charge lies below the standardised charge.

We appreciate that for CIU investments, external ratings are not always available. However, where an ECAI has rated a fund, some reliance could be placed on the rating for regulatory purposes. We strongly encourage the Commission to review ECAI rating practices for funds before finalising its proposal. Where a rating is not available, the Commission should allow investors to default to the standardised approach as a fallback. We certainly do not support and strongly question the proposed 200% risk weight floor applied to exposures of the highest credit quality.

## ANNEX: Risk Assessment of CIUs

Related to the discussion above, and with specific reference to non-ETF CIUs, the eligibility criteria act to circumvent existing industry practice in the risk assessment of CIUs which has developed in the last decade. We are concerned that by focusing on transparency alone, insufficient consideration has been given to a prudent assessment of risk, which may lead to increased concentration in firms' positions – where they remain in the market. The risk assessment process discussed here is not suitable for incorporation in legislative terms, and to be clear, we do not advocate that this process be enshrined within the eligibility criteria. Indeed, many of the points discussed below are not relevant for ETFs, particularly passive tracker funds. However, a requirement for there to be adequate risk assessment of CIUs can, if necessary, be amplified via a Level 3 (non legislative) mechanism. To provide greater context to this issue we offer the following illustrative overview of industry assessment of the main risk factors in CIUs.

**Liquidity risk in the underlying asset classes** refers to the risk that redemptions, which are granted in the legal documents of the CIU cannot be met by the CIU due to illiquidity of the assets invested in. This is generally addressed in the due diligence process where a mismatch between nominal liquidity of the CIU and the liquidity of the invested asset classes is addressed. Additional comfort is gained through an independent fund administrator, which refuses to execute transactions in assets which are not covered by the constituting documents of the CIU. This is a tested procedure, which is viable for both on-shore and off-shore CIUs. In practice, determining the liquidity of individual holdings within each CIU would not be viable for a financial institution which has holdings in many hundreds of CIUs.

**Strategy risk.** Similarly, the risk of individual strategies pursued by CIUs is not actually assessable in a look-through fashion given that a data consolidation over many hundreds of operationally diverse institutions is not feasible. This issue is amplified by the fact that most non-ETF CIUs pursue actively managed strategies, which are inherently hard to assess solely on the basis of looking through to the individual CIU constituents. Instead, strategy risk for these types of CIU is based on a strict due diligence on the CIU's compliance and internal risk management functions.

**Risk of strategy change.** Similarly, the risk of a strategy change in the CIU is addressed by referring to the CIU's constituting documents for on-shore funds or to investment guidelines imposed on off-shore funds. Investment guidelines for off-shore funds work in conjunction with specific transparency provided by the independent administrators of a CIU. Again, additional comfort is drawn from a strict due diligence on the CIU's compliance and internal risk management functions with respect to style drift.

**Operational and fraud risk** cannot be reliably addressed by transparency alone, since fraud and operational issues almost invariably involve a misstatement of traded positions. The keys to manage this aspect of risk are independent provision of NAVs and an independent administration of CIUs along with a strict due diligence on the CIU's legal organisation.

We hope it is clear from the points made above that efficient risk management in relation to investment in CIUs should not be based solely on full transparency, although we accept that this is a necessary condition for full look-through treatment for market risk capital purposes. Of equal importance is transparency on key risk factors, which feed into appropriate investment guidelines. Also the role of operational and fraud risk is largely neglected by drawing false comfort from full transparency.

The key tool for risk management of CIU exposure is simply diversification. The exposure to a large number of funds instead of an outright exposure to a concentrated portfolio of CIUs allows financial institutions to manage the risk involved. Thus, an unmodified proposal would actually amplify the risk exposure of financial institutions to CIUs since it would dramatically reduce the set of CIUs which can be invested in to a few vehicles, which offer the onerous degree of transparency outlined in the proposal. Such a shrunken universe of CIUs would render broad diversification as the main tool of operational risk management not viable and would lead almost certainly to a strongly concentrated exposure to a few CIUs.